

Quarterly Review of Investment Strategy

Bernalillo County, NM



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Bernalillo County Investment Committee

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Fiduciary Standard

Investment Priorities

Investment Priorities

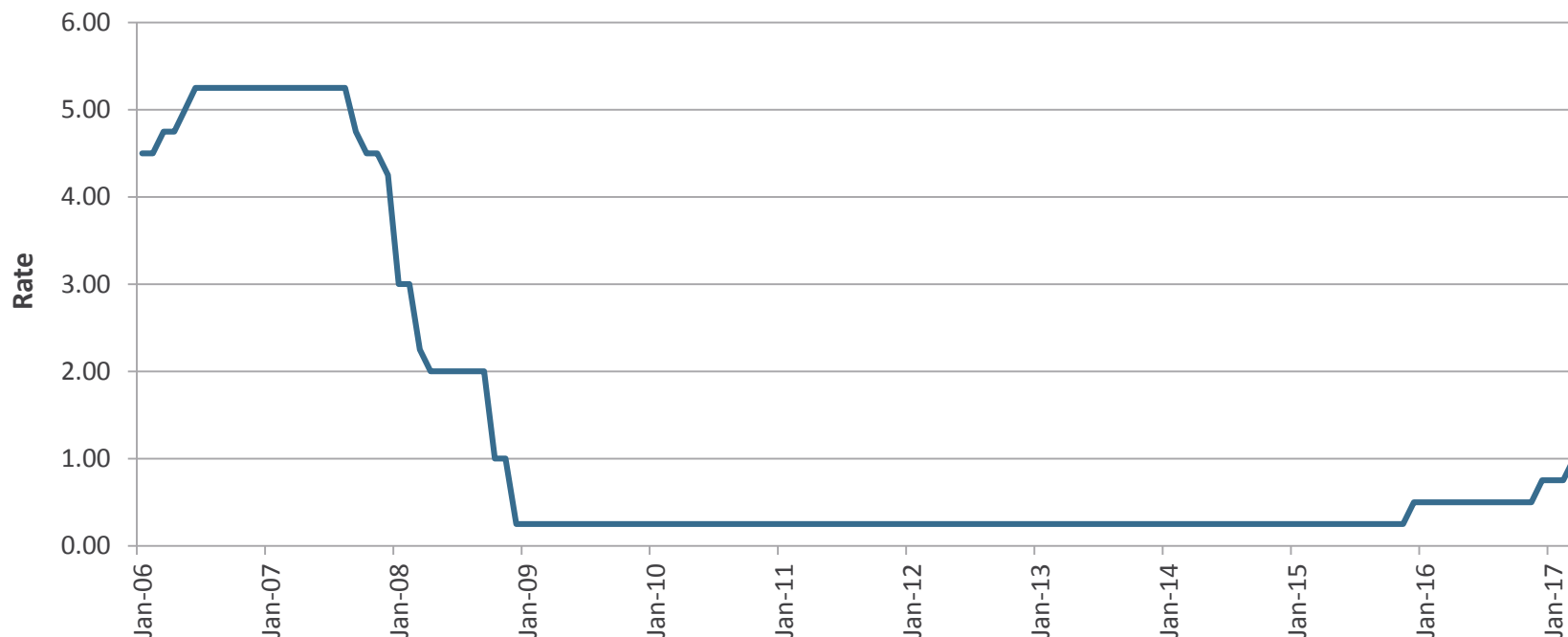
Our investment objectives and philosophy are consistent with all of our clients:

-  ***Safety is primary objective***
-  Transparency
-  Compliance
-  Liquidity
-  Yield

Economic Update

Economic Overview

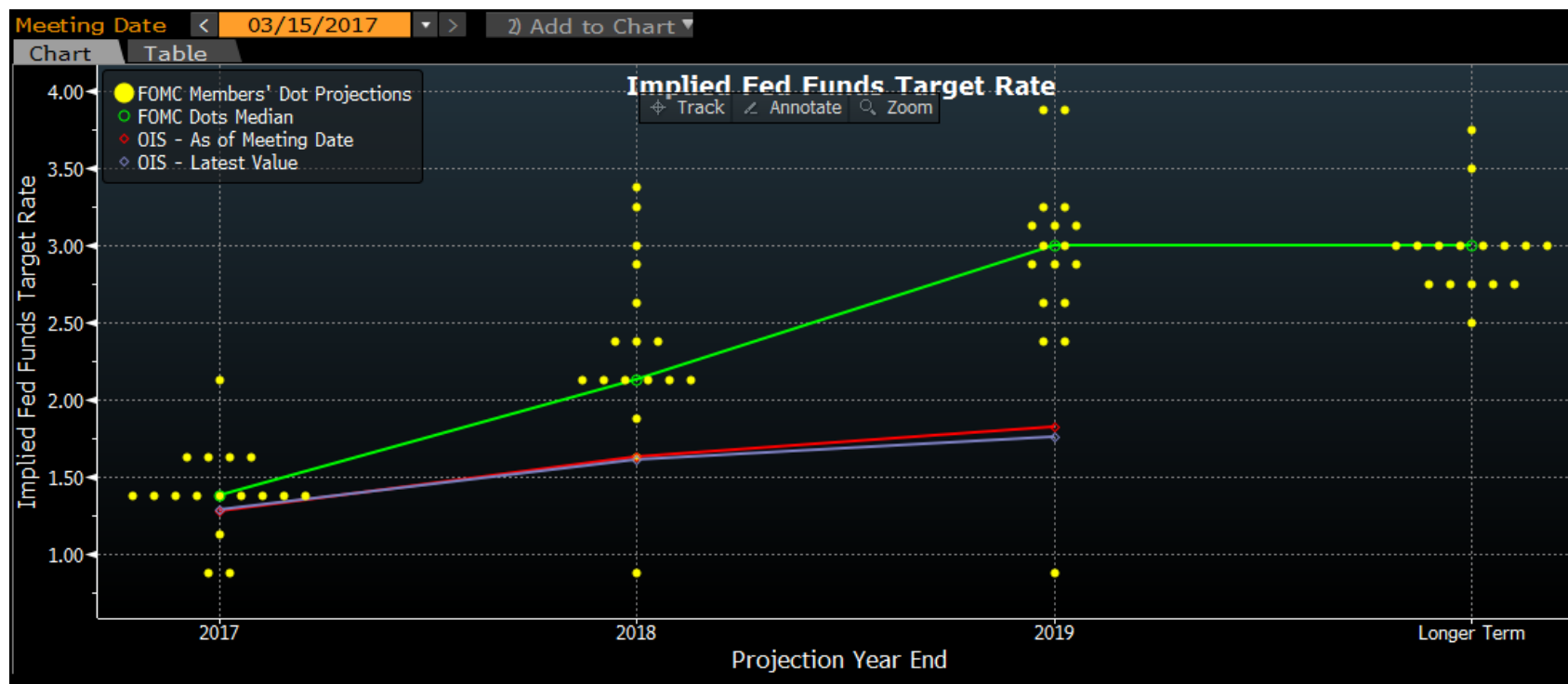
Fed Funds Target Rate



- The Federal Reserve increased its target rate to a range of 0.75% to 1.00% on March 31, 2016
- The Fed's Mandate - maximum employment and price stability

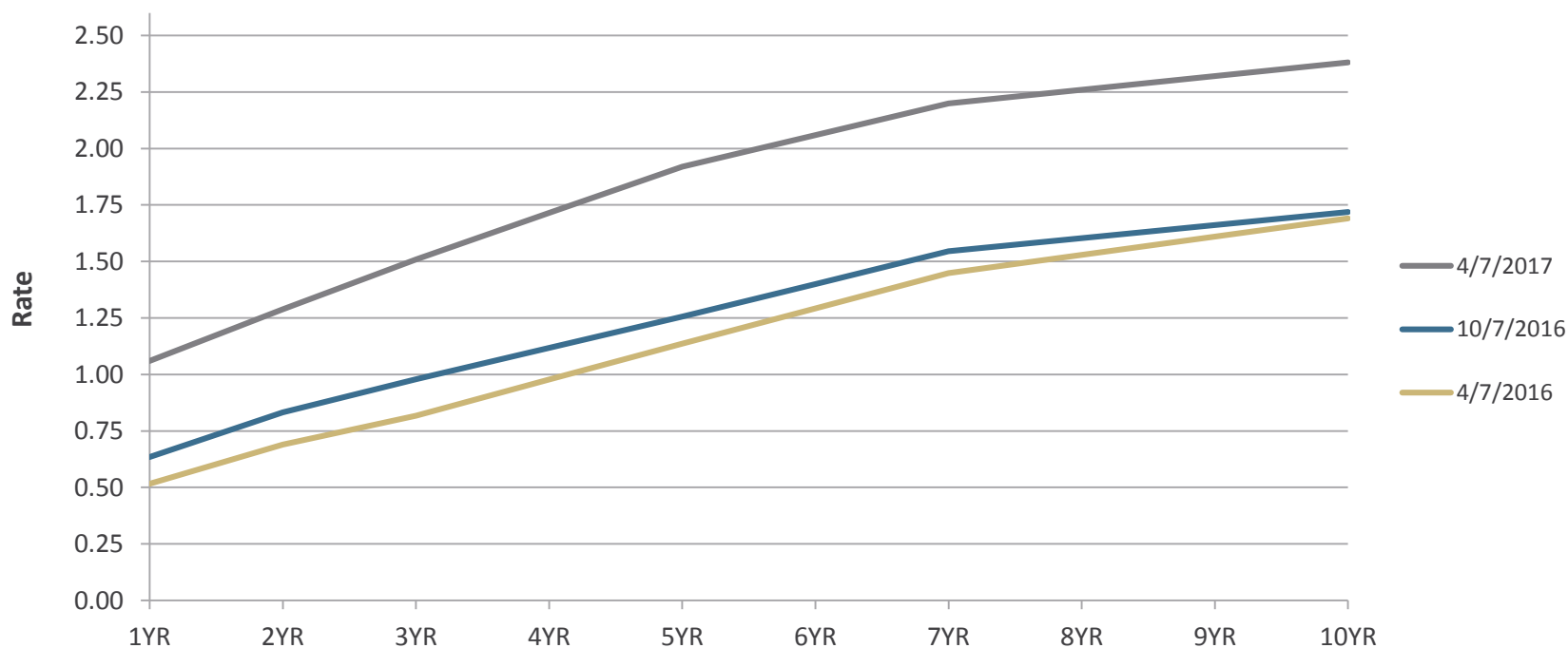
Economic Overview

FOMC Dot Plot – March 2017



Economic Overview

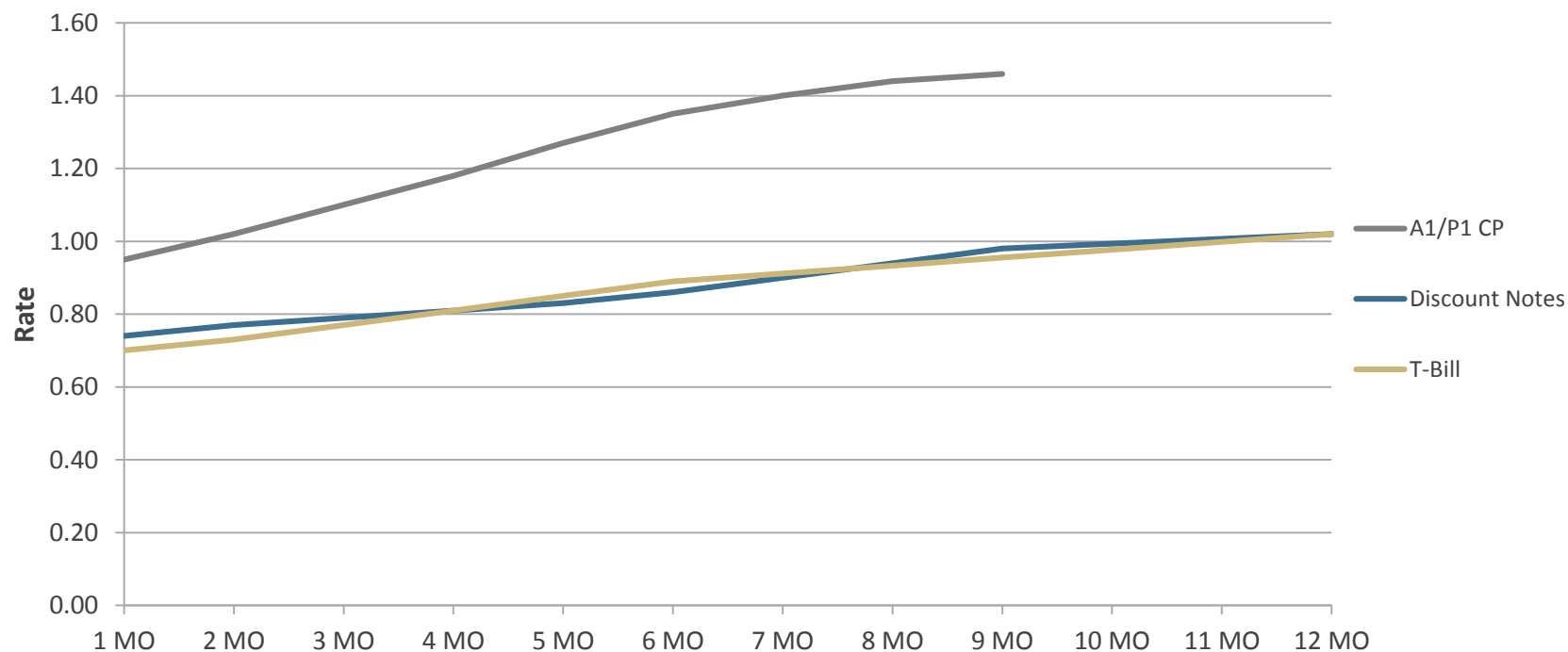
Comparative Historical Yield Curves



- The Fed was highly successful in driving down interest rates to all-time lows
- Interest rates have increased for all maturities along the yield curve as investors expect stronger growth and higher inflation going forward

Economic Overview

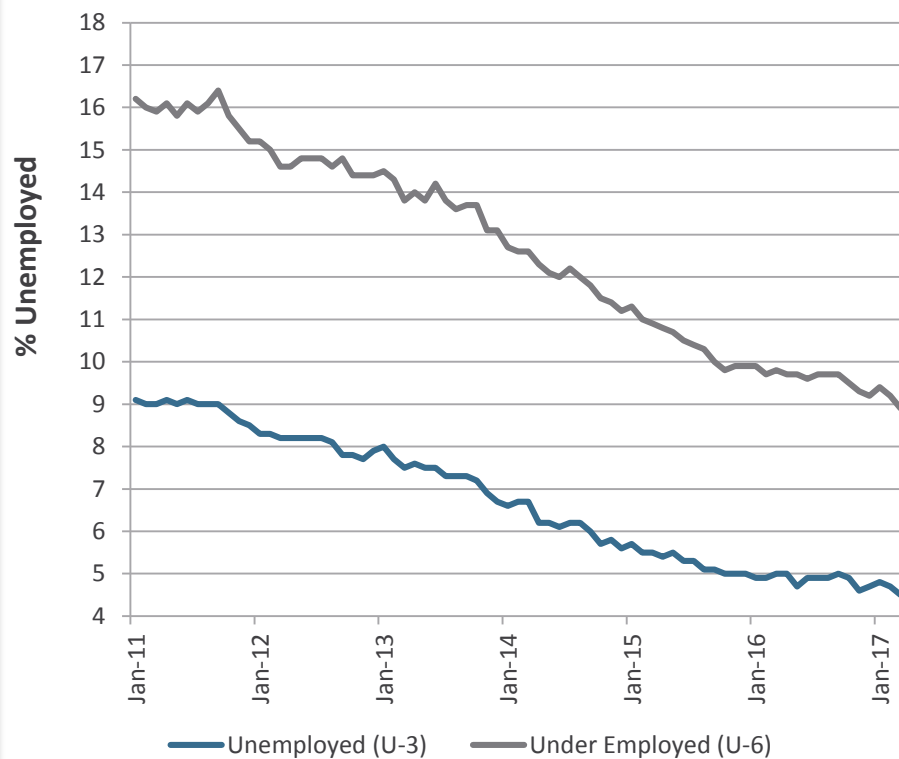
Money Market Yield Curves



- Yield spread between Treasuries and commercial paper widened significantly due in part to money-market reform
- Adding credit in the form of commercial paper enhances the yield of the portfolio
- Money market yields have risen following the FOMC rate increase in December 2016

Economic Overview

US Unemployment Rate



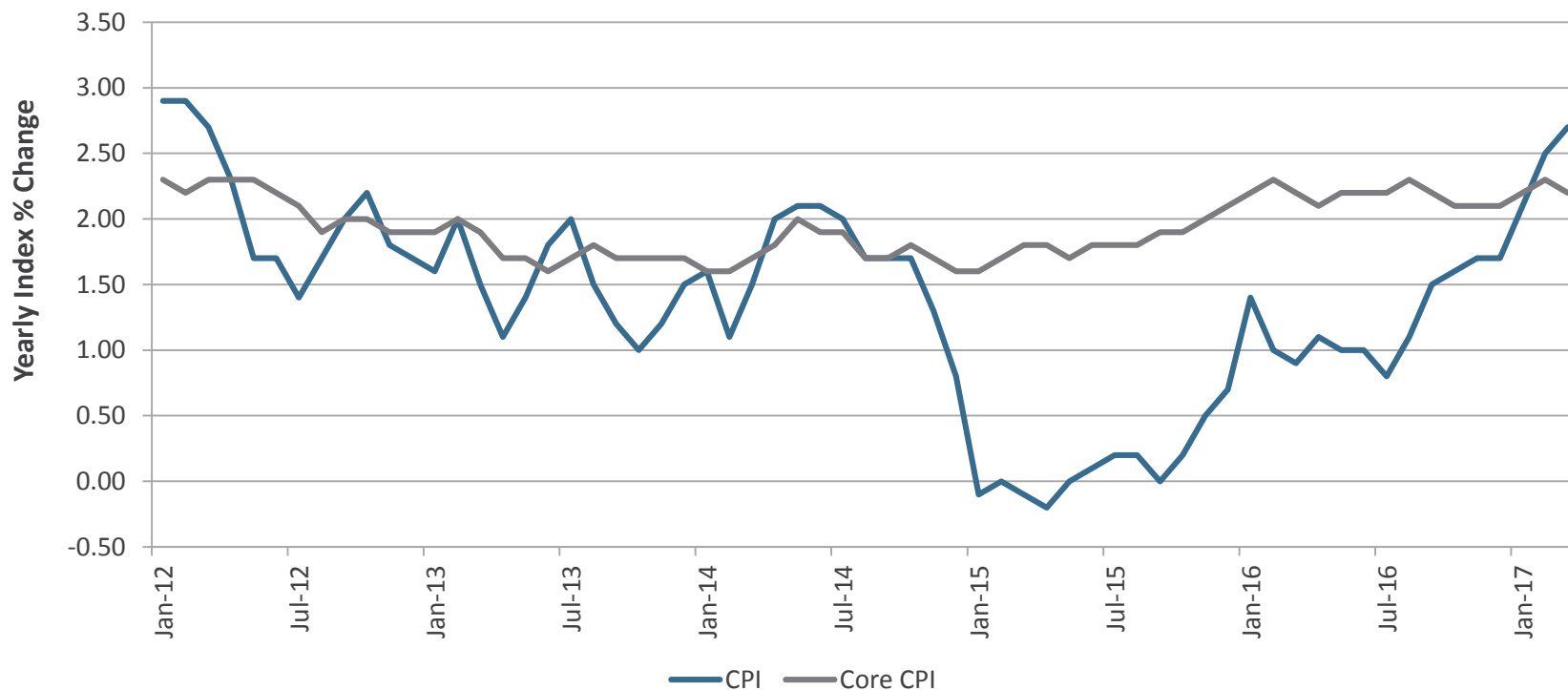
Nonfarm Payrolls



- The March unemployment rate fell to 4.5% from 4.7% in February
- March jobs creation was weaker (+98k) following the February number of (+219k), with winter weather likely impacting the March report

Economic Overview

Consumer Price Index



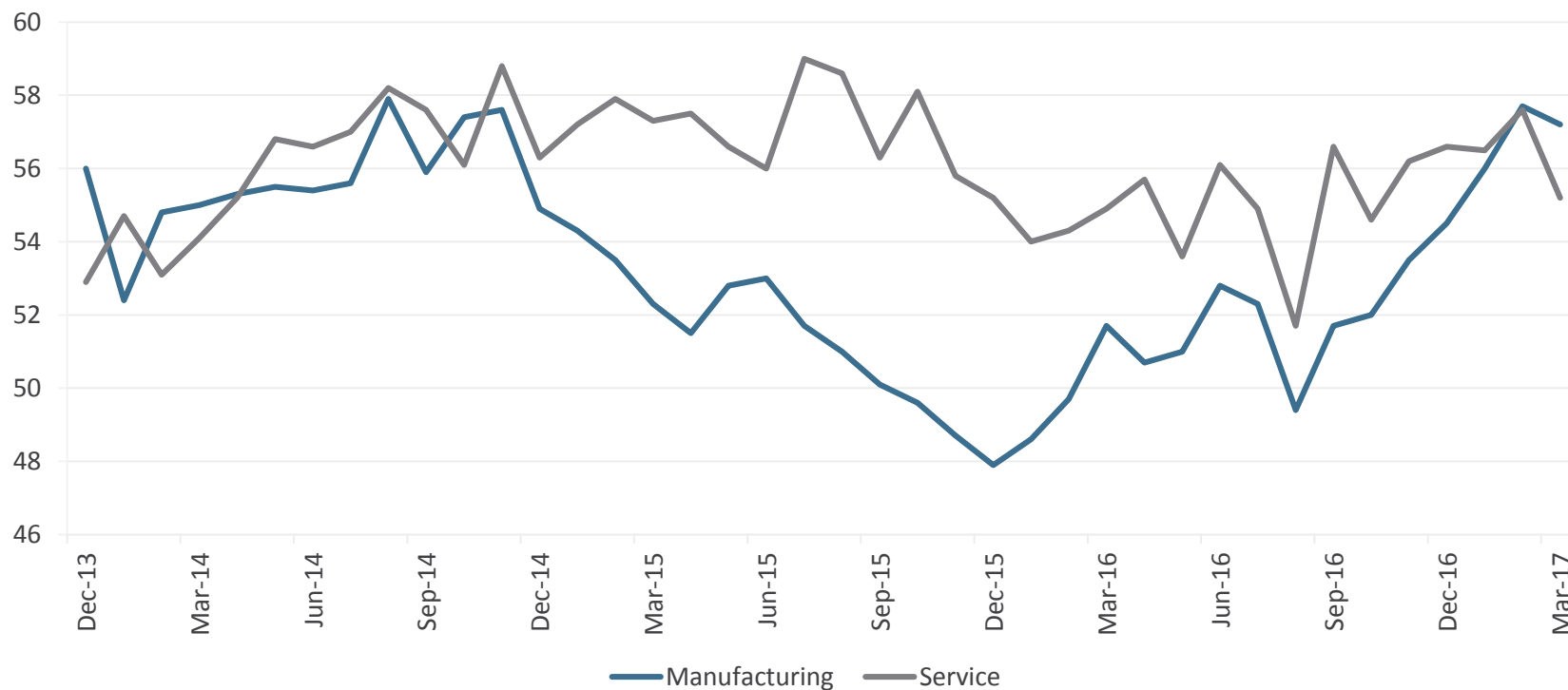
The Fed is optimistic that inflation will trend towards the long run target of 2%



As can be seen in the graph above, both Headline CPI and Core CPI have crested the 2% threshold

Economic Overview

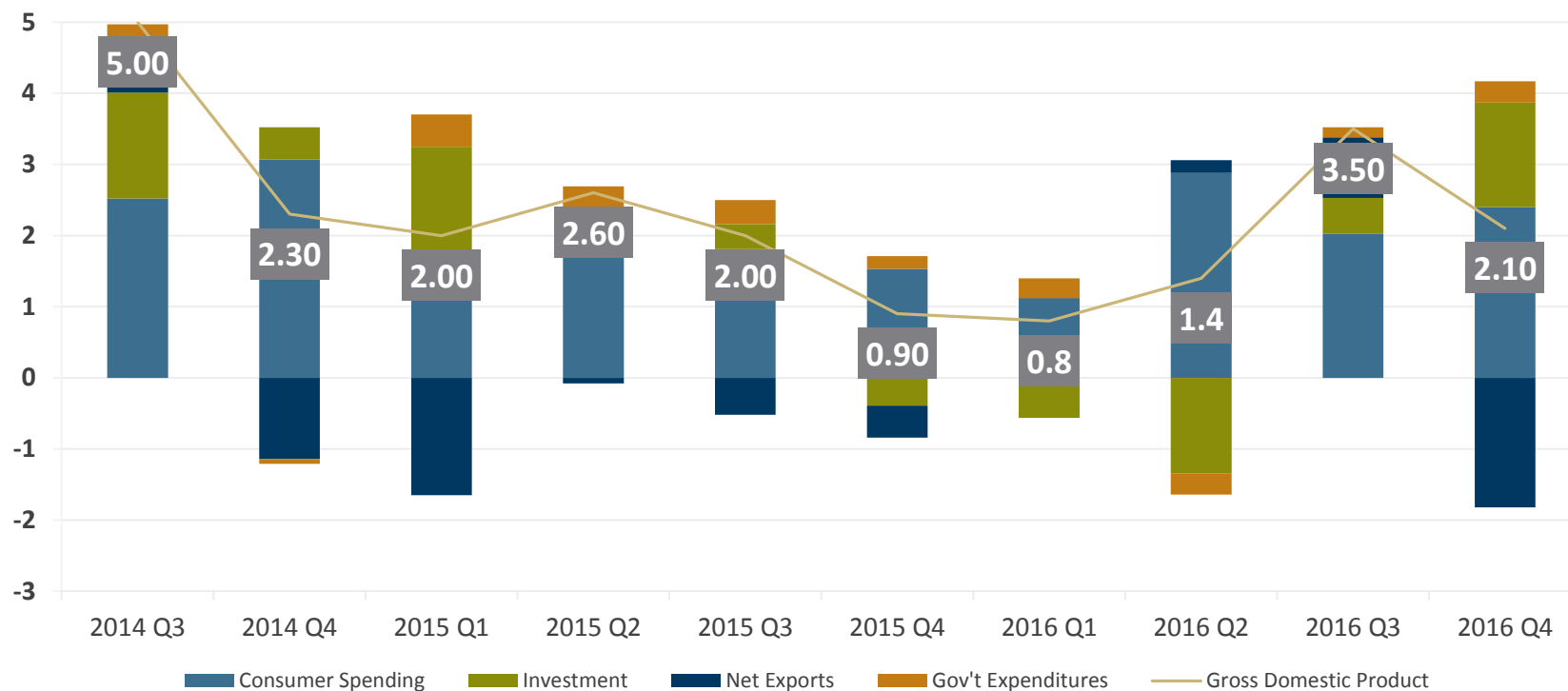
Institute for Supply Management



- ISM Manufacturing for March was 57.2 signaling expansion
- Manufacturing has expanded for seven straight months (>50)
- ISM Non-manufacturing for March was also relatively strong with a reading of 55.2

Economic Overview

Contributions to Percent Change in Real Gross Domestic Product



- The U.S. economy expanded at a 2.1% annualized pace during the fourth quarter of 2016
- The first quarter may be weaker with growth around 1.00%
- Outlook for growth is expected to average 2.0-2.5% for the foreseeable future

Investment Strategy – Operating Funds Portfolio

Fiscal Year 2016 – Previous Quarter Strategy*

Operating Funds Portfolio

- The focus of the working group continues to be on putting more cash to work for the County to improve investment earnings.
- As of December 31, 2016, 62.6% of the County's operating funds held in cash accounts (negotiated savings accounts) versus 79.1% in the same period in 2015. The working group has been able to put more money to work (invested out the curve v. bank deposits), significantly improving yield.
- Cash balances are typically high at the end of the calendar year due to property tax collections, which have yet to be distributed to other taxing entities. Over 70% of taxes collected to distributed 30 days after collection.
- The upward shift in interest rates on the short end of the yield curve provides opportunity to more efficiently invest the required liquidity portion of the portfolio.
- The new County Treasurer is being briefed by the Investment Working Group regarding the history of the strategy and data necessary to set the course for investment strategy going forward in her administration.

US Treasury and Agency Yields Year-over-Year 2015-2016



Source: Bloomberg.

Bernalillo County Operating Funds Portfolio – March 31, 2017

	Market Value + Accrued	% of Total	Book Yield
Summary of Investment Funds:			
US Treasury Securities	\$ 104,493,095.12	40.83%	0.900%
US Agency Securities	\$ 24,822,245.90	9.70%	1.158%
Cash - Wells Fargo MMF	\$ 10,455,470.37	4.09%	0.580%
Cash/Receivable	\$ 4,369.64	0.00%	0.00%
Summary of Negotiated Bank Deposits:*			
Wells Fargo Savings	\$ 55,648,589.86	21.74%	0.173%
First National Bank Santa Fe	\$ -	0.00%	0.250%
Bank of the West	\$ 39,511.21	0.02%	0.276%
Total Month-end Bank Balances	\$ 55,688,101.07	21.76%	
CDARS/ICS			
First National Bank Santa Fe	\$ 20,105,506.50	7.86%	0.500%
Bank of the West	\$ 40,375,189.81	15.78%	0.660%
Total Month-end CDARS/ICS Balances	\$ 60,480,696.31	23.63%	
Total Investable Funds	\$ 255,943,978.42	100.00%	0.873%
Previous Month Total Investable Funds	\$ 247,472,630.33		0.655%

Bernalillo County Operating Funds Portfolio (ex. Bank Products)

Balance Sheet Summary

	Bernalillo County Op Funds
Book Value	139,929,967.27
Accrued Balance	295,341.42
Net Unrealized Gain/Loss	-450,127.66
Market Value + Accrued	139,775,181.04

Net Income

	Bernalillo County Op Funds
Current Units	139,859,840.01
Interest Income	108,729.83
Net Amortization/Accretion Income	-6,357.15
Net Realized Gain/Loss	0.00
Net Income	102,372.67

Index Comparison Summary

Risk Metric	Portfolio	Index	Difference
Duration	1.319	0.986	0.333
Yield	1.109	1.011	0.098
Years to Effective Maturity	1.341	0.995	0.346
Years to Final Maturity	1.341	0.995	0.346
Average Credit Rating	AAA	AAA	---

Fixed Income Holdings by Market Sector

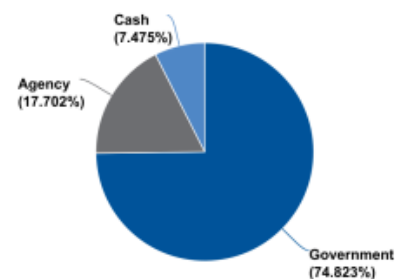
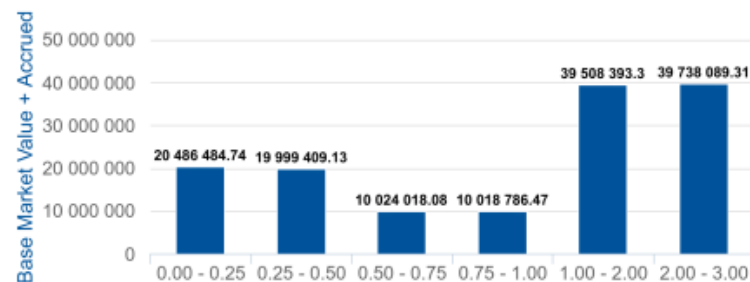


Chart calculated by: % of Book Value

Duration



Index: BofA ML 1-Yr TBILL

Investment Strategy - Operating Funds

- The focus of the working group continues to be on putting more cash to work for the County to improve investment earnings.
- Currently, the duration on the \$129.5 million operating funds managed portfolio is 1.197 years and is benchmarked to the 1 year T-bill.
- The remainder of the funds have been invested in Bank Savings Deposits with overnight liquidity, which in effect, makes the duration of the overall portfolio well short of 1 year.
- The question is, does the county need virtually the entire portfolio to be liquid (defined as maturing within one year) or is there opportunity to carve out another core portfolio with a somewhat longer duration strategy for enhanced performance, while maintaining safety and sufficient liquidity?
- The investment working group has been discussing creating a third portfolio for the county for efficient management and enhanced performance.
- Slides to follow cover creating a CORE portfolio

Strategy by Fund Type

Create investment strategies by fund type:

Operating Funds – Create 2 investment strategies for operating funds:

- **Liquidity** Bucket – This fund or portfolio would be established to pay for all operating expenses over a normal business cycle, plus some reserves.
 - Benchmark – 1 year T-bill
 - Includes the 15% Liquidity requirement that must mature within 30 days
 - ~\$60 million
 - Includes smooth ladder of \$5mm monthly maturities – month 2-12
 - \$55 million
- **Core** Portfolio Bucket – This is the long-term strategic investment portfolio. Consider a maximum maturity of 5 years, per policy.
 - Benchmark – 1-3 year Treasury/Agency

Creating a **Core** Portfolio – Policy Considerations

Investment Policy already contemplates the use of both Liquidity and Core portfolios, but the portfolio has been managed as if all funds are in the Liquidity bucket.

Investment Policy Section **IV: Identification of Funds**

C. The Operating Funds Investment Portfolio is comprised of funds not immediately needed in cash balances to cover county expenses and debts. The Portfolio is separated into two primary components based upon the expected cash flow needs of the County.

1. **Liquidity component** provides funds for short-term cash needs of the County. The liquidity component is expected to have minimal liquidity risk and all investments in this component are constrained to investments of less than one (1) year duration.
2. **Long-term component** comprises cash that is not reasonably expected to be necessary to meet the short-term cash flow needs of the County. Accordingly, it may be invested over a longer term than the liquidity component as specified by the maturity restrictions of Section VIII B.

Creating a **Core** Portfolio – Policy Considerations

Investment Policy already contemplates the use of both Liquidity and Core portfolios, but the portfolio has been managed as if all funds are in the Liquidity bucket.

Investment Policy Section **VIII: Investment Parameters**

B: Maturity Restrictions

2. Maturity limits for the liquidity component:

- (a) An amount equal to at least fifteen (15) percent of the annual budget of the County on the day the budget is passed and adopted shall have a maturity limit of thirty (30) days or less.
- (b) The remainder of the liquidity component shall have a maturity limit of one (1) year or less.

Core Portfolio:

Strategies for The Added Value Approach For Portfolio Management

Our portfolio management and credit team coordinate with the investment advisor and client to determine the optimal approach based on our initial Client Review. We apply qualitative and quantitative methods for portfolio management with the goal of adding value to the investment program versus a purely passive investment approach.

- **Interest Rate Forecasting:** Forecasting is utilized to gauge the probable term structure of interest rates over our investment horizon and measure the impact on a portfolio's return over time. We can then implement maturity structure strategies based on expectations of increasing or decreasing interest rates.
- **Maturity Distribution:** Our strategy is to utilize a percentage of benchmark approach to duration management. We will typically reduce duration compared to the benchmark in a rising rate environment and move the duration to, or possibly slightly longer than the benchmark in a falling rate environment. This strategy can add value through income and/or lower price volatility as interest rates change.
- **Shape of Yield Curve:** As part of the maturity structure approach, the shape of the yield curve can shift during increasing and decreasing interest rate environments. Market conditions, liquidity stemming from supply and demand conditions, as well as realized and anticipated changes to monetary policy by the Federal Reserve can impact the shape of the yield curve. Steep yield curves offer an advantage of larger gains in yields for each unit of duration and a flat yield curve may result in a more cautious approach to longer term investing as a result of limited yield advantage for greater interest rate risk.
- **Asset Allocation:** Economic and geopolitical events often impact the term structure of interest rates. As demand for safe haven investments such as U.S. Treasuries increases (decreases), investors will typically demand a higher (lower) relative returns on other asset classes such as municipal debt. Adjusting asset allocation targets as part of a dynamic investment process may add value to the overall investment program from additional income and sector outperformance for a given period.

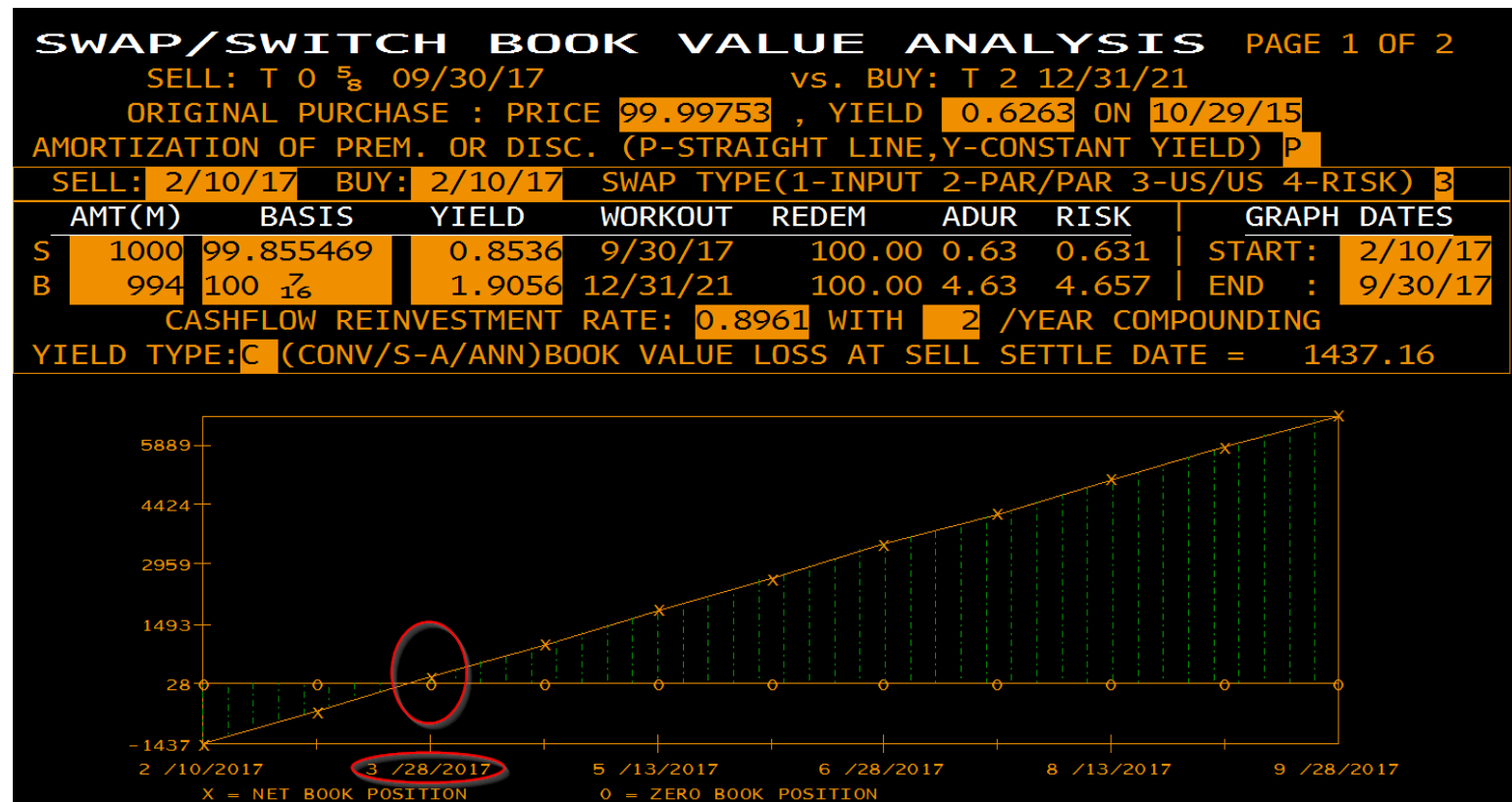
Active Portfolio Management: Example of a Sample Transaction

Transaction Example

- In a rising interest rate cycle every fixed income portfolio is likely to accumulate some unrealized losses.
- Portfolio managers that outperform understand the value in taking a short-term loss that can be recovered by the maturity date of the original investment security sold, via reinvesting in a higher yielding security.
- At a high level, this trade effectively “swaps” the loss and the lower coupon payments until the old security’s maturity for a new investment with a current higher market coupon stream.

Swap Example

1. Recover a loss taken on Feb 10th by March 28th of the same year
2. Earn higher returns for the final 6 months the original bond would have been held.



Transaction Example

Left column shows details of “old” bond sold.

Details of Security Sold	
CUSIP	912828TS9
Original Settlement Date	10/29/2015
Issuer	T
Coupon	0.625%
Maturity Date	9/30/2017
Par Amount	2,000,000
Dollar Price	99.9883
Principal Cost	1,999,766
Last Coupon	9/30/2015
Accrued Interest	990
Total Cost	2,000,756.07
Book Yield	0.63%
Original Discount	(234)
<hr/>	
Sale Date	2/10/2017
Book Value at Sale	1,999,921
Sale Price	99.941
Sale Principal	1,998,828
Last Coupon Date	9/30/2016
Accrued Interest	4,567
Total Proceeds	2,003,396
Gain on Sale	(1,093)
Sale Yield	0.72%

Right column details the “new” bond purchased.

Details of Security Purchased	
CUSIP	912828U81
Settlement Date	2/10/2017
Issuer	T
Coupon	2.000%
Maturity Date	12/31/2021
Par Amount	1,987,000
Dollar Price	100.578125
Principal Cost	1,998,487
Last Coupon Date	12/31/2016
Accrued Interest	4,501
Total Cost	2,002,988
Book Yield	1.88%
Original Premium	11,487
<hr/>	
Review Date	9/30/2017
Book Value at Review	1,997,040.27
Last Interest Before Review	6/30/2017
Accrued at Review	9,935
Total Proceeds at Review	2,006,975
Additional Cash Put Up	-

Transaction Example

Left column shows earnings given up from bond sold.

Right column shows new higher earnings from new bond purchased.

Details of Earnings Sold (Through 09/30/2017)

Remaining Accruals	7,933
Remaining Accretion	79
Net Earnings Sold	8,012

Details of Earnings Purchased (Through 09/30/2017)

Coupon Accruals	25,304.06
Premium Amortization	(1,447)
Net Earnings Purchased	23,857

Below is a summary after netting the two columns above.

As can be seen, after accounting for the earnings sold and loss on the sale + adding back the new higher earnings purchased the investor is better off by \$14,752 by the time the old bond would have matured on 9/30/2017.

Summary of Swap Earnings

Gain/(Loss) Realized on Security Sale	(1,093)
Net Earnings Sold	(8,012)
Net Earnings Purchased	23,857
Total Additional Earnings	14,752

Investment Strategy – Bond Proceeds Portfolio

Fiscal Year 2016 – Previous Quarter Strategy*

Bond Proceeds Portfolio

- Maintain the course.
- This portfolio strategy is to structure investment maturities to meet the cash needs of the capital projects currently underway.
- The portfolio is invested in a smooth ladder of securities with \$1.5 million maturing each month to fund capital project draws.
- The County is set to issue debt on February 21, 2017.

Bernalillo County Bond Proceeds Portfolio

Balance Sheet Summary

	Bernalillo County Bond Proceed
Book Value	23,148,105.49
Accrued Balance	39,334.23
Net Unrealized Gain/Loss	-24,295.98
Market Value + Accrued	23,163,143.74

Net Income

	Bernalillo County Bond Proceed
Current Units	23,158,302.42
Interest Income	14,134.69
Net Amortization/Accretion Income	669.76
Net Realized Gain/Loss	0.00
Net Income	14,804.45

Index Comparison Summary

Risk Metric	Portfolio	Index	Difference
Duration	0.598	0.986	-0.388
Yield	0.92	1.011	-0.091
Years to Effective Maturity	0.603	0.995	-0.392
Years to Final Maturity	0.603	0.995	-0.392
Average Credit Rating	AAA	AAA	--

Fixed Income Holdings by Market Sector

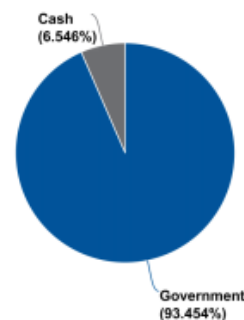
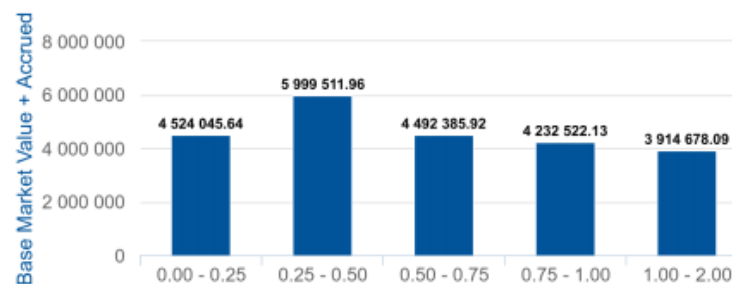


Chart calculated by: % of Book Value

Duration



Index: BofA ML 1-Yr TBILL

Investment Strategy – Bond Proceeds

- Maintain the course.
- This portfolio strategy is to structure investment maturities to meet the cash needs of the capital projects currently underway.
- The portfolio has been invested in a smooth ladder of securities with \$1.5 million maturing each month to fund project draws.
- Each maturity will be evaluated against the most current project draw information to determine if funds will be drawn down or reinvested.
- The most recent bond issuance of \$19+ million is invested in an even ladder of maturities from June 2018 to December 2018 (7 months) based upon project management cash flow analysis performed by the County.
- The County is set to issue debt to fund in March 2018.

Registered Investment Advisor – Standard of Care

Per Public Trust Advisors' current scope of work for Bernalillo County, we are required to prepare a quarterly investment review and present it to the Investment Committee and the Board of Finance. As a Registered Investment Advisor (RIA) under the Securities Exchange Act of 1940, we act in a fiduciary capacity for the County.

*A **fiduciary** relationship is generally viewed as the highest standard of customer care available under law. Fiduciary duty includes both a duty of care and a duty of loyalty. Collectively, and generally speaking, these duties require a fiduciary to act in the best interest of the customer, and to provide full and fair disclosure of material facts and conflicts of interest.*

~ Securities Industry and Financial Markets Association (SIFMA)

SIFMA Fiduciary Standard Resource Center, <https://www.sifma.org/issues/private-client/fiduciary-standard/overview/>

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